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Income Averaging And Losses: An IRS Change Of Position

Neil Harl
Iowa State University, harl@iastate.edu

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Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

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Issue Contents

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INCOME AVERAGING AND LOSSES: AN IRS CHANGE OF POSITION

— by Neil E. Harl[*]

From the time of enactment in 1997 of income averaging for those involved in a farming business,[1] effective in 1998,[2] the question has been raised about how to handle losses in the three carryback or "base" years.[3] Although the Internal Revenue Service has resisted efforts to allow negative taxable income to figure in to the calculations, recent publications appear to allow the use of negative figures.[4]

For 1998 and 1999, Schedule J did not allow the use of negative taxable income for a base year (any of the three carryback years).[5] That position led to criticism of the IRS position. It is significant that the proposed regulations did not address the issue of whether negative taxable income in the election year or in the base years could be included in income averaging calculations.[6]

***Farmers Tax Guide* position**

The 2000 edition of the *Farmers Tax Guide*[7] states as follows—

> "If your taxable income for any lease year was zero because your deductions exceeded your income, you may have negative taxable income for that year to combine with your EFI [elected farm income] on Schedule J."[8]

Moreover, after noting that Schedule J for 1998 and 1999 did not allow taxpayers to use negative taxable income for a base year, Publication 225 states—

> "…you can now file amended returns on Form 1040X to do so. If you did not use Schedule J for 1998 or 1999 and this change would make using it beneficial, you can amend your returns to elect its use. If you used Schedule J for 1998 or 1999 and your taxable income for any base year was zero, you can amend your return to refigure your tax (or to revoke your election)." [9]

The instructions to the 2000 Schedule J contain guidance on how the calculations are to be handled.

Negative income for year of election

Another significant issue is whether a taxpayer can treat, as "elected farm income," negative income for the year of the election. If that were possible, the negative figure could be used to reduce the income tax paid as an alternative to the regular loss

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[*] Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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carryback rules.[10] The income averaging statute[11] defines "elected farm income" as "so much of the taxable income for the taxable year" attributable to any farming business which is "specified in the election."[12] The term "taxable income" is defined as "gross income minus the deductions allowed by this chapter (other than the standard deduction)"[13] with no provision or restriction for reducing taxable income below zero.[14] For that reason, "elected farm income" could be negative.

However, the income averaging statute[15] specifies that "the increase in tax imposed by section 1 which would result if taxable income for each of the 3 prior taxable years were increased by an amount equal to one-third of the elected farm income" is to be added to the tax in the year of the income averaging election on "taxable income reduced by elected farm income."[16] Therefore, it would appear that negative elected farm income figures in the year of the election cannot be used to reduce the tax liability as calculated with reference to the three carryback years. [17]

Who will benefit from new interpretation

Farmers and ranchers with significant losses during the three carryback years will gain from the new interpretation. In particular, hog producers who suffered substantial losses in late 1998 and early 1999 will be among the prominent gainers.

FOOTNOTES

1 I.R.C. § 1301(a) enacted by Pub. L. 105-34, Sec. 933(a), 111 Stat. 881 (1997).

2 See generally, 4 Harl, *Agricultural Law* § 26.08 (2000); Harl, *Agricultural Law Manual* § 4.01[4] (2000); Harl, "Income Averaging," 8 *Agric. L. Dig.* 177 (1997); Harl, "New Income Averaging Regulations," 10 *Agric. L. Dig.* 165 (1999). Legislation was enacted in 1998 to make income averaging permanent (it was initially enacted only for 1998, 1999 and 2000). Pub. L. 105-277, Sec. 2011, 112 Stat. 1214 (1998).

3 See Harl and McEowen, "Reporting Farm Income," TM 608.

4 *Farmers Tax Guide*, Pub. 225, pp. 22-23, 2000.

5 Schedule J, Form 1040, 1998, 1999.

6 See 64 Fed. Reg. 54836, Oct. 8, 1999, Prop. Treas. Reg. § 1.1301-1. See generally Harl, "New Income Averaging Regulations," 10 *Agric. L. Dig.* 165 (1999).

7 Pub. 225, pp. 22-23.

8 *Id*.

9 *Id*.

10 See I.R.C. § 172(b),(i).

11 I.R.C. § 1301(b)(1).

12 I.R.C. § 1301(b)(1)(A).

13 I.R.C. § 63(a).

14 Id.

15 I.R.C. § 1301(a)(2).

16 *Id*.

17 See Harl and McEowen, "Reporting Farm Income," TM 608.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ANIMALS

STRAYS. The plaintiffs found 11 cattle on their property which had strayed off the defendant's land. The plaintiffs filed suit in small claims court for the cost of keeping the animals until they were returned to the defendants. The defendants argued that Or. Stat. § 85.1 et seq. Did not allow recovery of maintenance costs where the owners of the animals is known to the person keeping the animals. The court held that the statute applied to domestic animals which included cattle and upheld the small claims court award of damages. **Berry v. Young, 6 P.2d 1070 (Okla. Ct. App. 2000)**.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

ABSOLUTE PRIORITY RULE. The debtor was a nonprofit agricultural cooperative which issued patronage stock to its members as patronage dividends. The debtor's Chapter 11 plan provided that the members would retain their patronage stock but only provided a 19 percent payment to one class of unsecured creditors. The plan treated the patronage stockholders as creditors of the debtor. The court held that patronage stock was in the nature of equity interests and the plan provision allowing stockholders to retain their equity interest while unsecured credits did not receive full payment violated the absolute priority rule and required that the plan not be confirmed. **Southern Pacific Transp. Co. v. Voluntary Purchasing Grps., Inc., 252 B.R. 373 (E.D. Tex. 2000)**.

AUTOMATIC STAY. The debtor owned property which was contaminated. The contamination spread to neighboring properties and to the town's drinking water. The commonwealth spent funds to clean up and contain the contamination and sought reimbursement for the debtor. When the debtor refused to reimburse the commonwealth, the commonwealth sent the debtor a notice of intent to file a lien against the debtor's property. During the administrative hearings on the lien, the debtor filed for Chapter 11 and sought to stay the lien proceedings. The commonwealth argued that the perfection of the lien was excepted from the automatic stay by Section 546(b) because the commonwealth had an interest in the property which was